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Temperance in Business

By D. M. FARISH, C.A.

Northern Electric Company, Ltd., Montreal.

(Before Vancouver Chapter, April 13, 1933.)

IT seems to me when we are, I believe, approaching the end of an extended period of poor business conditions, that we should stop to consider the lessons we have learned during such a period as it appears to me that business depressions, as they are called, come periodically so as to impress upon us more vividly the mistakes we have made in the years of business prosperity.

Reviewing briefly our government situation, we find Canada with a population of 10,000,000, with a Dominion government and nine provincial governments, the operating expenses of which alone are a tremendous load on the population, apart from the numerous so called capital expenditures which they also have, many of them only resulting in additional yearly carrying charges without beneficial results. An illustration of this is the money which was expended on the Canadian National Railway during the past few years.

Public Expenditures

Although the present system of governments was not instituted of recent years, I certainly believe that since 1929 we have all realized that not only has our Dominion government got to be more temperate with regard to its operating expenses and capital expenditures but, in addition, considerable changes in our provincial governments are essential and it seems to me only logical that New Brunswick, Nova Scotia and Prince Edward Island Governments should amalgamate as the Maritime Provinces, and Alberta, Manitoba and Saskatchewan governments as the Central Provinces. In addition there must be a substantial reduction in the number of members in the Dominion and provincial governments. Changes along these lines are necessary if we are to obtain the relief in taxes which is so essential. Is it not time to find out what we can afford to pay for government administration?

The last period of prosperity has resulted in practically all industrial companies over-building their plants, with the result that their output capacity is considerably in excess of business requirements for some considerable time. Probably the most outstanding example of this situation is the paper industry, but unfortunately hardly any industry has escaped. It is certain that in the future far more temperate action will govern plant extension and that more thought will be given to working plants in shifts, thus utilizing the plant more hours per day rather than making extensions to plant and equipment.

Companies have also omitted to be temperate with regard to their selling, distribution and administration expenses in times of prosperity, and we must give more thought to the control of these expenses henceforth. Standards have been developed with regard to manufacturing which are used to measure the efficiency of manufacturing, particularly from a cost standpoint, but we have not progressed very far in developing measures of efficiency with regard to selling and distributing expenses.

DISTRIBUTION SALARIES—EXPENSE PER BILL

[illegible]

(A) Based on 4085 Bills.

(*) Based on average of 23 full working days per month.

() Based on average of 20 full working days per month.
In establishing salary cost per bill average of \$100.00 per employee per month used.

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Control of Distribution Salaries

During the past three years when studies of expenses have been given very serious consideration, we have developed several controls of expenses or measures of efficiency. I have prepared an exhibit covering the control of distribution salaries which may prove of interest to you.

Distribution salaries include the salaries of employees responsible for an order from the time it is received until the merchandise is shipped and the invoice issued to the customer. You will notice the salaries are divided into six classifications and that a monthly and daily load quota per employee has been established for each classification, from which the actual employees required can be ascertained based on the number of bills per month.

Two standards were established—"B" being the minimum objective and "A" the maximum objective. The last column represents the actual performance when the standards were set and you can quickly see the substantial saving possible, even if only "B" standard is obtained.

This measure will be of untold value when prosperity returns and will aid us in being more temperate as far as this class of expense is concerned.

As citizens we were also much to blame during prosperity as our mode of living was far from temperate, and our free spending and our demands on governments and municipalities without reasonable caution encouraged governments, municipalities and companies to spend and expand freely. I am wondering if as citizens we have really learned our lesson, or if when money is more easily earned we will not be as reckless as ever in spending and investing.

As business men we must give as much thought or more to expenditures of our respective companies' money than we give to our personal expenditures. By thus being temperate in our business actions we should avoid to some extent violent fluctuations in business volume, which should result in keeping employment on a more satisfactory basis.

I am wondering if we will learn the lesson of being temperate in our business actions from the experiences of the past few years, when we have prosperity with us once more, as I am sufficiently optimistic to believe that we are just turning the corner for better times although progress will probably be slow.

Judge: "Have you ever seen the prisoner at the Bar?"

Witness: "Never, my lord; but I've seen him when I strongly suspected he had been there!"

* * * *

Voter: Congratulations. You certainly made yourself clear on the liquor question.

Politician (startled): Did I?

You sure did, sir.

Heavens! What a blunder!

* * * *

What do you make a week? asked a judge of the organ grinder.

Twenty dollars, Your Honor.

What? Twenty dollars for grinding an organ

No, Your Honor, not for da grind—for da shut up and go away.

Exchange Fluctuations in Relation to Accounting as Regards Operating Results and Asset Values

BY A. E. CUTFORTH, C.B.E., F.C.A.

(Before the Fourth International Congress on Accounting, London,
Eng., July, 1933.)
(From "The Accountant")

THERE are few items of public information which remind us more vividly or more frequently of the economic vicissitudes to which the various countries of the world are subject from time to time than the quoted rates of exchange—in other words, the relative values of the currencies of the different countries.

The disadvantages of a currency not fixed by some more or less universal standard, such as that of gold, have always been recognised by students of economics and also by financiers, traders and others who are brought into frequent touch with the practical aspects of the question.

For a number of years prior to the great war the general tendency was towards the stabilization of the exchanges; and it seemed likely that at no very distant time the currencies of nearly all the civilised nations of the world would to all intents and purposes become fixed as between each other; in other words, that the variations would be so slight as to cause little or no inconvenience to the flow of international trade and incidentally to present no difficulties to the accountant.

Effect of the Great War on Currencies.

The outbreak of the European war profoundly altered this situation. Financial transactions between enemies immediately ceased. As regards other channels of trade and finance, some were stimulated, some were diverted, and others were destroyed altogether. The belligerent nations borrowed money to the best of their ability, firstly from their own nationals, and then, so far as they were in a position to do so, from other nations. The money so borrowed may be said to have been blown into the air, destroying lives and property in the process. Small wonder was it, therefore, when at last the struggle came to an end, that the exchanges were in a chaotic condition. Nor was it easy to create new standards with any firm expectation that they would prove permanent. The unsolved problems of the settlement of inter-ally debts and of reparations, with their repercussion not merely upon the finances of the nations concerned, but upon the trading operations of their peoples with each other and with third parties, obscured the horizon. Added to this, political disturbances hindered, in many countries, the return to ordered progress.

And to-day, nearly fifteen years after cessation of hostilities, there seems little prospect of the currencies of the chief countries of the world being stabilised in their relation to each other in the near future. Accountants therefore must be prepared for some long time to come to record or to verify from accounting records transactions taking place in fluctuating currencies.

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Assumption in Regard to the Currency in which Balance Sheets and Profit and Loss Accounts are Submitted.

The first axiom which will, I suppose, be universally admitted is that the statements of account showing the position of any business, i.e., the balance sheet and the revenue account or profit and loss account, must be presented in terms of the currency of the country where the owners of that business are domiciled. For example, a public corporation in the United States of America may own a number of public utility undertakings in South America. The detailed records of these various enterprises, kept in South America, will, of course, appear in the local books of account in the currencies of the countries where such enterprises are situated, as the local transactions take place in those currencies. But the annual balance sheets and profit and loss accounts which would require to be furnished to the shareholders in the United States of America, if presented in terms of, say, Brazilian milreis or Argentine pesos, would probably be unintelligible to the proprietors who received them, or, what is worse, misleading. It therefore follows that while the transactions in foreign countries—and the term “foreign” is used as meaning countries other than that where the owners of a business are domiciled—have to be recorded in the local currency in which they take place, the system of accountancy must be such as will enable a proper picture, showing the state of the affairs of the business, to be presented at regular intervals in terms of the currency of the home country.

As has been noted, the owner of a business naturally looks at transactions in the light of the currency of his own country. In other words, he instinctively tries to convert, in his mind, transactions in a foreign currency to their equivalent in terms of the currency of his own country. Such a man is therefore apt to regard the currency of his own country as being the stable currency and the currencies of foreign countries with which he does business as fluctuating currencies. Great Britain departed from the gold standard in the autumn of 1931, and the United States of America departed from the gold standard in the spring of this year, 1933. In 1932, therefore, the currency of the United States was fixed in relation to gold, whereas the currency of Great Britain was a fluctuating one. But the Englishman in 1932 would still require the accounts of businesses in which he is interested to be presented in terms of sterling, and would take no cognisance of the fact that the pound sterling was no longer linked to gold. An English farmer, with a predilection towards keeping a reserve of cash in his house, may have had stored away in 1930 fifty golden sovereigns. Early in 1931 he may have expended thirty of these on the purchase of a cow. The remaining twenty were only brought from their hiding place in 1932, when they were required for the purchase of another cow. The farmer knew that these twenty sovereigns no longer formed part of the currency of his country, but that he could sell them to a dealer in gold in exchange for currency. He did so, and they realised, let it be assumed, £26, with which he bought another cow. What have his two cows cost him? Before he bought his first cow he possessed currency (represented at that time by golden sovereigns) amounting to £50. After he had completed in 1932 the purchase of his second cow he had exhausted his funds and had in their place two cows. If he thought in terms of gold he would say that his two cows had cost him £50. But if he thinks—as the ordinary man would do—in terms of currency he would say that his two cows had cost him £56, and that the excess of this sum over the £50 which he had in 1930, namely £6, represented a profit on the realisation of the twenty gold sovereigns in 1932. His books of ac-

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count have certainly to be kept in terms of the currency of his country; and they should therefore record the first cow as having cost him £30 and the second cow £26.

Assumption that Accounting Records are concerned with at least Two Currencies.

It is perhaps unnecessary to mention that when one is referring to the treatment of fluctuating currency in accounts, one has not in mind the cases where the transactions are taking place and the accounts are kept wholly in one country, although such country's currency may be a fluctuating one when measured by a gold standard. One is considering the case of where two or more countries are concerned, and where the values of the currencies fluctuate in relation to each other. And, for the reasons already given, one has to proceed on the assumption that the currency of the country in which the owners of the business are domiciled is, for bookkeeping purposes, to be deemed to be the fixed currency, and the currencies of the other countries with which or in which transactions are taking place as the fluctuating currencies.

II.—MAIN PRINCIPLES OF CURRENCY CONVERSIONS FOR THE PURPOSES OF THE BALANCE SHEET AND THE PROFIT AND LOSS ACCOUNT

Textbooks which deal with the treatment of a fluctuating currency in accounts lay down the following four main principles in regard to the preparation of a balance sheet and a profit and loss account in terms of a fixed currency:—

- (i) that capital expenditure, incurred in fluctuating currency, should be converted into the fixed currency at the rate of exchange prevailing when the expenditure was incurred.
- (ii) that floating assets (other than stocks) and liabilities in the fluctuating currency should be converted into the fixed currency at the rate of exchange prevailing on the date as at which balance sheet is drawn up.
- (iii) that stocks of goods in hand at the date of the balance sheet, which have been purchased in the fluctuating currency, should be converted into the fixed currency at the rates of exchange prevailing at the times when they were acquired. Goods purchased for re-sale should be written down to market value if such is less than their cost.
- (iv) that profits earned in a fluctuating currency must be converted into fixed currency at the average rate of exchange prevailing during the time when the profits were earned. The same principle would, of course, apply in regard to losses.

As will be appreciated, a number of points of interest and importance arise in practice in the application of the foregoing principles; and it will be convenient to group them under the four heads set out above.

III. CAPITAL EXPENDITURE

Firstly then, there can be considered questions incidental to the recording of capital expenditure.

Composition of Capital Expenditure.

Speaking in general terms, capital expenditure may be said to be composed firstly of wages, secondly of materials, and thirdly of a number of administrative and other charges incurred on capital account. One is speaking, of course, of cases where a business or undertaking carries out its own capital expenditure, and not of cases where the expenditure is placed in the hands of a contractor or of cases where fixed assets are bought in a complete state, as, for example, a works or a factory.

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Wages paid on Capital Account.

For the purpose of ascertaining the equivalent, in terms of the fixed currency, of the wages paid in the fluctuating currency on capital account, it is the usual practice to convert the monthly totals of the wages at the average of the daily rates of exchange prevailing during the month, or in cases where the fluctuating currency does not vary very greatly in value, to convert the totals quarterly, half-yearly, or yearly. The choice between dealing with the totals at short or at longer intervals depends firstly on the extent of the variations in the value of the currency and secondly on the question of whether the capital expenditure is being incurred more or less evenly over a financial period or whether it is much heavier in some months than in others. In case of doubt it is preferable to choose the shorter periods, as this procedure, while entailing a little more work and trouble, certainly yields the more accurate results. One may take as an example the case of an English company owning a railway system in the Argentine Republic. During a particular financial year the average rate of exchange, let it be assumed, has been such that twelve Argentine paper pesos have been equivalent to £1 sterling. A capital expenditure programme has been in progress throughout the year, and the total capital expenditure on wages during the year has amounted to 6,000 pesos. The conversion of 6,000 pesos into sterling at the rate of 12 pesos to the £ gives a sterling equivalent of £500. But on closer examination it is ascertained firstly that of the 6,000 pesos no less than 5,000 were expended during the first month of the year, and first month of the year also that during that month 10 pesos were worth £1 sterling. Obviously there should be attributed to these 5,000 pesos a rate of 10 pesos to the £, instead of the average rate of the year. 5,000 pesos at the rate of 10 pesos to the £ equal £500, while at the rate of 12 pesos to the £ they only equal about £417. The basis of applying to the 5,000 pesos the average rate of exchange applicable to the year would therefore result in the capital account being undercharged by about £83; and the case clearly calls for the conversion of monthly totals at the average monthly rates of exchange. It will, of course, be realised that the conversion of the totals of even so short a period as a month at the average monthly rate of exchange does not achieve absolute accuracy. If absolute accuracy were sought to be secured, then presumably the conversion of the wages applicable to each day should be made at the rate of exchange of that day. But the accountancy system is the servant and not the master of a business, and no accountant would go so far as to suggest that the extra work involved in the daily conversions was a reasonable price to pay for the extra degree of accuracy obtained.

As will be explained later, the application of inappropriate rates of exchange for the purpose of making conversions from one currency to another for bookkeeping purposes does not always perpetuate an error; the error may be automatically adjusted in the same or in the next financial period. This does not, however, apply where capital expenditure is concerned. An over debit, or an under debit to a capital expenditure account creates an incorrect figure which remains on the books in perpetuity—except, of course, to the extent to which it may gradually be reduced from year to year by the writing off of depreciation or be removed by the sale of the asset. It will be appreciated also that an overcharge or undercharge to capital account automatically entails an overstatement or an understatement of profits.

Occasionally specious arguments are put forward, in perfectly good faith, in support of a departure, in certain circumstances, from the generally accepted principle in regard to the conversion of capi-

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tal expenditure. For example, the Argentine currency was at one time, practically speaking, fixed in relation to English currency on a basis which gave to the Argentine paper peso a value of about 1s. 9d. The subsequent decline in value of the Argentine currency (the rate in February 1933 was about 1s. 6d.) did not cause a proportionate rise in prices in the Argentine expressed in Argentine pesos. For the purposes of this illustration let it be assumed that there had been no rise at all in the rates of wages in the Argentine, expressed in Argentine pesos. An English company may have been engaged on a capital expenditure programme necessitating the disbursement of a considerable sum in local wages, and this work may have been in progress during the time when the Argentine exchange began to fall. The directors of such a company may conceivably say to themselves: "For every 100 pesos which are being spent on labour, just as much work is being done as was the case before the Argentine currency fell in value in relation to sterling. For a number of years past we have converted the Argentine currency into sterling for the purpose of our capital expenditure and other accounts at the par rate of exchange. When judged by that standard, the capital expenditure incurred in currency is still worth par to us, and we propose to continue to convert it at par." A little reflection will show the fallacy of such an argument. In the first place, capital expenditure is not recorded in books of account at what the parties interested may think is its real value to them; it is recorded on the basis of what it actually cost. In the case under consideration, the expenditure incurred when the Argentine peso fell in value became, when expressed in sterling, correspondingly lighter. The same number of pesos may, it is true, have purchased the same amount of labour as before, but from the standpoint of sterling the cost was less. In the second place the pesos so spent were in liquid form: not improbably they formed part of a currency bank balance. Had they still been in that state when the balance sheet was prepared, they would have been valued, in common with other currency floating assets, on the basis of the rate of exchange prevalent at that date; that is to say, at a rate considerably under par. The fact that they have been converted from a floating asset into a fixed asset, namely from cash at bankers to capital expenditure, is no justification for attributing to them any higher sterling equivalent than the equivalent at the time when they were spent. Indeed, to attribute such higher value to them is tantamount, as has already been mentioned, to overstating profits: in other words, an overcharge to capital account involves an undercharge or an over-credit to revenue account.

Profits and Losses on Currency Floating Assets and Liabilities incidental to Capital Expenditure.

Difficult questions sometimes arise in connection with exchange profits and losses on currency floating assets and liabilities which are incidental to a capital expenditure programme. There is firstly the question of principle, that is to say, whether such exchange profits or losses should be credited or debited to capital account, or whether they should be taken to profit and loss account.

For example, it occasionally happens that considerable liquid resources are specially accumulated in the fluctuating currency preparatory to being spent on capital account. These funds, which are probably represented by cash at bankers, increase or decline in value as the rate of exchange fluctuates; and it may be that they are of considerably less value at the time when they are expended than at the time when they were first accumulated. It would seem reason-

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able, in view of the fact that these liquid resources did not form any part of the floating capital necessary for the carrying on of the business or undertaking—that is to say, for its maintenance or operation—but were definitely earmarked for capital purposes, that any loss occurring owing to a decline in the rate of exchange between the time when they were accumulated and the time when they were expended, should be debited to capital account as being incidental to the capital expenditure programme and in no way connected with the revenue account. On the other hand, those responsible for the preparation of the periodical accounts of such a business or undertaking might well decide that in spite of the justification for the charging of such a loss to capital account, it would be preferable, as a measure of financial prudence, to write it off to revenue account, in order that the charges to capital account may be limited to the actual cost of the fixed assets acquired or constructed, and shall not contain any losses of floating capital, although such losses may be incidental to the capital expenditure programme, and quite unconnected with revenue.

In considering the above question it is of interest to bear in mind the legal interpretation of "profits available for dividend." One is speaking now, of course, of the position from the point of view of the law of England. The legislature has carefully avoided attempting to define "profits" and those of us who, as practising accountants, are brought almost daily into touch with the practical aspects of the question realise that a satisfactory definition is an impossibility. In specific cases, however, which have come before the English courts for decision, certain principles have been indicated by the judges: and one of these principles is to the effect that in arriving at profits available for dividend, losses of floating or circulating capital must be made good but that losses of fixed capital need not necessarily be made good. So far as its form is concerned, cash accumulated at bankers with a view to its subsequent expenditure on capital account is clearly floating capital. But it is not floating capital in the sense that it is necessary for the ordinary carrying on of the business and is being used for that purpose. It appears to the writer therefore, that the dicta of the judges referred to above cannot be regarded as implying that, under all circumstances, exchange losses on floating capital which is destined to be converted into fixed capital must be written off to profit and loss account.

It seems difficult to say more than that—

- (a) each case must be judged on its own merits;
- (b) in cases where the arguments both pro and con seem to be equally strong, it is well to err on the safe side. That is to say, that if there is no loss it should be written off to revenue account, and if a profit it should be taken to the credit of capital account; and
- (c) if a loss on exchange is debited to capital account this should be shown separately in any statement of accounts and not included as part of the actual cost of the fixed assets: similarly, a credit to capital account should be shown separately.

As will be appreciated there is an alternative course in appropriate cases which, in a sense, combines the two methods of treatment, and that is to hold up the loss in suspense on the assets side of the balance sheet temporarily and then to write it off to profit and loss account over a series of years.

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A not altogether dissimilar situation, in principle, arises where, in order to pay for capital expenditure incurred in a country whose currency fluctuates, a loan is raised from a bank in that country. If, subsequent to the time when the loan is raised, the currency appreciates in value, there is a corresponding increase in the amount of the liability; and as the liability had been expressly incurred for capital purposes it might be argued that instead of the loss arising from the increase in this liability being written off to profit and loss account, it should be charged to capital account as being incidental to the capital expenditure. It is submitted, however, that this principle is not one which would find acceptance among accountants.

A case arose not long ago where a company domiciled in England but engaged in business in the Union of South Africa, raised a loan (of a permanent nature) in South Africa, and purchased premises with the proceeds. At that time the currencies of both England and South Africa were on the gold basis, and therefore the South African pound was considered as being equivalent to the English pound. Consequently in the balance sheet (exhibited in England) the transaction (using hypothetical figures) appeared thus:—

Loan Account £100,000	Cost of premises £100,000.
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When, however, Great Britain departed from the gold standard, but the Union of South Africa still adhered to the gold standard, the English pound could no longer be treated as equivalent to the South African pound. In fact, four South African pounds became worth about five English pounds.

Consequently, when the next balance sheet required to be prepared in England, expressed in sterling, it appeared as follows:—

Loan Account	£125,000	Cost of premises	£100,000
		Loss on exchange in connection with loan of £100,000 in South African pounds	25,000
	£125,000		£125,000

The above is an instance of where a loss on exchange arose in connection with the acquisition of a fixed asset, and had nothing whatever to do with the ordinary operating results of the business: yet no accountant, it is suggested, would be found to declare that the loss was one which could be carried to capital account.

Another argument which is occasionally heard in support of the capitalisation of a loss incurred on floating capital in circumstances similar to those outlined is that if the owners of the undertaking had not carried out the capital expenditure programme themselves but had made an arrangement for a contractor to undertake it at a fixed price, that contractor would probably have had to provide liquid funds in the fluctuating currency somewhat in advance of the time when he required to spend them, or, alternatively, that he would have had to incur liabilities in the fluctuating currency; and that in view of the possible losses which he might conceivably have to incur by reason of variations in the rates of exchange he would increase his contract price. In such an event the owners of the undertaking would have charged the whole contract price to capital account, although it would have included a reserve for possible losses on exchange, and also presumably an amount representing the contractor's profit. The answer to such an argument, of course, is that the books must deal with the trans-

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actions in the form in which they actually occurred; and that the fact that under different circumstances capital would have been charged with a larger sum and revenue relieved of a certain amount of loss has no bearing on the matter whatever.

Quite apart, however, from the difficulties of laying down a fixed principle, there are frequently difficulties in the application of a principle. In the examples quoted above, it is easy to earmark a loss as being incidental to capital expenditure; but in other cases in actual practice it may be quite difficult to earmark, beyond dispute, a loss as being attributable to capital. And this practical difficulty strengthens the argument, in such instances, for writing the loss off to revenue account.

Materials used for Capital Purposes.

In so far as capital expenditure is composed of the use of materials, these may consist of materials purchased in the fluctuating currency of the country where the capital expenditure programme is being carried out or of materials imported from the country having the fixed currency. As regards the stores purchased locally it is essential to ascertain the value of these, expressed in terms of the fixed currency, at the time when they were purchased, for such value expresses their cost, and it is at their cost price that they require to be embodied in the capital expenditure account in the books. Further reference will be made to the question of stores in general later. As regards stores purchased in the fixed currency, no such difficulty arises.

Miscellaneous Expenses incurred in Currency on Capital Account.

With respect to items other than wages and materials which can enter into the composition of capital expenditure, it is perhaps unnecessary to make any comments except to mention that so far as the charges represent expenditure in the fluctuating currency they require to be converted into the fixed currency at the rate of exchange prevailing at the time when the expenditure was incurred. In actual practice this may be achieved by dealing with totals monthly, quarterly, half-yearly or yearly, as may be appropriate, and converting these totals at the average rate of exchange of the month, quarter, half-year or year.

Capital Expenditure usually transferred to Head Office Books.

Before leaving the subject of capital expenditure it should be mentioned that it is usually found most convenient, in the case of a business owned and controlled by parties in one country but operating in a country where the currency fluctuates, to transfer the capital expenditure accounts from the local books to the head office books, in which latter books the expenditure is, of course, recorded in the currency of the country where the ownership and control exists. The reason for this is that such expenditure is not subsequently affected by any fluctuations in the exchange. As and when, in the course of each financial year, new capital expenditure is incurred, or any fixed assets are sold or scrapped, the necessary information is furnished by the local office to enable the appropriate entries to be made in the books of the head office where the capital expenditure accounts are recorded.

Provision for Depreciation or Replacement of Fixed Assets.

Special points of importance sometimes arise in connection with the provision for depreciation of fixed assets which are in use in the country having the fluctuating currency.

It is to be noted that just as the fixed assets accounts are recorded in terms of the fixed currency, the reserves for depreciation of such assets require to be dealt with in a similar manner. For example, let it be assumed that a fixed asset, say some machinery, was purchas-

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ed for 100,000 Argentine paper pesos, and that it was thought necessary to make such a provision for depreciation as would amortise the cost of the asset in 20 years. It might seem at first sight as if this result could be achieved by debiting to profit and loss account each year for 20 years a sum of 5,000 Argentine paper pesos. Let it be presumed that at the time when the expenditure was incurred, the Argentine peso was worth 1s. 9d. The sterling equivalent of the expenditure would be £8,750. If during the 20 years the Argentine peso stood on average at the rate of 1s. 6d., it is clear that the depreciation reserve account, accumulated during the 20 years, would only amount at the end of that time to £7,500; in other words, it would be insufficient to amortise the cost of the asset at the end of its assumed economic life. It will therefore be realised that in order to maintain the depreciation fund on a proper basis, it will be necessary to charge, in arriving at the local profits of the business in each of the 20 years, such a number of Argentine pesos as at the average rate of exchange prevailing during such year gives a sterling equivalent of £437 10s.

The following matter may also be of importance in connection with provision for depreciation or renewal of fixed assets.

In most classes of undertaking it is customary to provide such a sum for depreciation as will write off the cost of a fixed asset by the time that the economic life of such asset has expired. Then, when another asset is purchased to take its place, the cost of the new asset is charged to capital account. The new asset, let it be presumed, is identical with the old: but it may cost less than the old asset originally cost, or it may cost more, as price levels may have changed considerably since the time when the old asset was acquired.

In some classes of undertaking, however, particularly in what are known as public utility undertakings such as railways, it is customary to allow the cost of the fixed assets acquired or constructed to remain permanently on the capital account and not to write off any depreciation; but to build up, by charges in the annual revenue account, a renewal fund, and then when the asset wears out and requires to be replaced by another similar asset, to charge the cost of the new asset against the renewal fund, irrespective of whether the new asset costs less or costs more than the asset which it has replaced. In deciding, therefore, what annual sums are necessary to be charged to profit and loss account and to be credited to the renewal fund in order that the renewal fund may be adequate for the purposes for which it was created, it is necessary to have regard to the probable cost of replacing the existing assets and not to the cost of the assets which are to be replaced. This aspect of the matter may be of considerable importance if the expenditure upon the original asset and also the expenditure necessary in order to renew that asset are in a currency which has fluctuated considerably in the past and may conceivably fluctuate considerably in the future. For example, a railway undertaking will have in its capital account the original cost of the rails, sleepers, &c., comprising its permanent way (i.e. its track) and such cost will include the labour costs of laying the rails and sleepers. These labour costs will be paid in the currency of the country; and, if the currency of that country is subject to wide fluctuations it may well be the case that the daily pay of a labourer engaged in the work of taking up old rails and sleepers and putting down new ones in their place, when converted into terms of the fixed currency (as would be necessary for accountancy purposes) is very different at the time when the renewing takes place from what it was when the rails and sleepers were originally laid down. If such is the case it may be necessary to modify

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the annual sums debited to revenue account and credited to the renewals fund in order to meet the anticipated costs of replacement.

While referring to provisions for depreciation, whether created in order to write down the original cost of the assets or whether carried to a renewal fund to provide for the cost of renewing the asset, it should be mentioned that it is usually found most convenient to keep any balances on these accounts in the main books of the business or undertaking, that is to say, the books kept in the country where the owners of the concern are domiciled, and not to leave them in the local books. As already mentioned, this will involve their being recorded in terms of the fixed currency, and not retained as balances on the local books in terms of the fluctuating currency. The reasons for such a course being desirable will be obvious: the provisions for depreciation have been built up year by year by charges in the annual profit and loss accounts or revenue accounts in the fluctuating currency in the local books. As the local currency has a different real value each year, it is clear that the aggregation, over a long series of years, of these annual currency charges would be meaningless. It is necessary to stabilise the annual totals by converting them into terms of the fixed currency.

IV. CURRENCY FLOATING ASSETS AND LIABILITIES

Dealing now with the question of currency floating assets and liabilities, the principle on which these should be converted, for balance sheet purposes, from the fluctuating to the fixed currency, is that of applying the rate of exchange prevailing at the date of the balance sheet.

As will be inferred from what has been stated earlier, the term "currency floating assets" as used in this connection is not intended to include stores purchased in currency, as these do not require to be valued in terms of the fixed currency by applying the rate of exchange prevailing at the date of the balance sheet. They must be valued at the rate in force at the time when they were purchased—in other words, at the equivalent of their cost. This principle is, however, subject to the qualification, in regard to goods purchased for re-sale, that they must be written down to their market value at the date of the balance sheet, if such value is less than their cost.

As a rule currency floating assets consist mainly of book debts and of cash balances at bankers and in hand; and currency liabilities include creditors for supplies and for accrued salaries and wages, and reserves for outstanding expenses payable in the fluctuating currency.

It will be appreciated that if the currency floating assets exceed the currency liabilities then a fall in the value of the fluctuating currency means a decline in the value attributed to the assets less the liabilities; in other words, there is a loss to be provided for. Conversely, if the currency liabilities exceed the currency floating assets, then a fall in the value of the fluctuating currency causes a profit to emerge on the books.

Unrealised Losses on Currency Floating Assets.

Occasionally the suggestion is put forward that it is unnecessary for a loss on exchange in connection with currency floating assets less liabilities to be computed and provided for until such loss is realised, as will be the case when the currency book debts, &c., have been liquidated, the currency liabilities paid off, and the balance remaining has been remitted and so converted into the fixed currency. In support of this argument it is submitted that the currency floating assets less liabilities represent permanent liquid capital for the local needs of the business; that when that capital was first provided there

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was no depreciation in the local currency; and that although the book debts are in constant process of realization in cash, and the cash is in constant process of being used to discharge local liabilities, the balance being remitted home, yet other book debts, other cash balances and other liabilities are concurrently being created. "Why not, therefore," say the supporters of this argument, "allow this floating capital which is permanently necessary for the needs of the business, to be valued at the old par rate? As and when remittances occur, the profits or losses on these will be brought automatically into the accounts. Is not this sufficient, bearing in mind that unless the business is to be closed down the necessary floating capital will never be remitted?"

This doctrine, according to the canons of good accounting, is unsound. The currency floating assets less liabilities represent circulating and not fixed capital; and in a balance sheet expressed in terms of a fixed currency, the floating capital cannot be said to be intact if it is included at a figure in excess of its real value on the date of the balance sheet. It is true that the loss owing to the depreciation of the local currency is an unrealised loss at the date of the balance sheet, but the loss is nevertheless a real one, and must be provided for.

Another suggestion which is sometimes encountered concerns a case where at the date of a balance sheet there is shown to be a loss on the revaluation of the currency floating assets less liabilities, but where subsequent to the date of the balance sheet there was an improvement in the rate of exchange in consequence of which the loss was subsequently made good. It is argued that in such a case there is no need to provide for the loss. It is conceded, of course, that if, under circumstances such as these, the unrealised loss at the date of the balance sheet is provided for, a corresponding profit automatically emerges in the next financial period. It is submitted, however, that there is no logical justification for setting the one off against the other. The loss is in fact a loss attributable to the old accounting period, that is to say, the period to the date of the balance sheet, whereas the profit is a profit properly attributable to the new accounting period, i.e. the period subsequent to the date of the balance sheet.

It will be appreciated that the principle laid down involves as a corollary that if at the date of a balance sheet there is no loss arising on the revaluation of the floating assets less liabilities, but it can be clearly shown that owing to a fall in exchange subsequent to that date the floating assets ultimately realised less than the valuation figure, there is nevertheless, no need to provide for such loss in preparing the balance sheet. This is admitted: the loss is the loss attributable to the new financial period and not to the old. In an extreme case, however, it may be deemed advisable as a measure of financial prudence, to make some reserve as at the date of the balance sheet, to provide for such a loss. It is, for example, conceivable that in the absence of the creation of such a reserve, the shareholders in a limited liability company might consider that the company's liquid resources permitted of the payment of a dividend at a certain rate out of the profits disclosed by the balance sheet and accounts, whereas owing to the subsequent severe decline in the value of the currency floating capital insufficient resources were available. The fact, however, remains that a balance sheet would be drawn up quite correctly which did not provide for such a loss.

It is of interest to compare the principle on which currency book debts are valued for balance sheet purposes with the principle on

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which book debts in general are valued, that is to say in regard to what provision, if any, should be made for ultimate loss on realisation. Let it be assumed, for the sake of illustration, that among the debts owing to an English company at its balance sheet date were the following:

- (a) a debt of £100 from an English customer;
- (b) a debt of 1,150 Argentine paper pesos from an Argentine customer, the sterling equivalent at the date of the balance sheet being £100.

Some four months afterwards, when the English company was completing the preparation of its balance sheet, it is ascertained that owing to the insolvency of the English customer only £80 would be received in respect of the debt of £100: and that as regards the customer in the Argentine, the debt had been collected in full in paper pesos, but owing to the fall in the Argentine exchange subsequent to the date of the balance sheet, the proceeds when remitted to England only amounted to £80.

As regards the English debt, it would clearly be incorrect to value it for balance sheet purposes at any figure in excess of £80. As regards the Argentine debt, however, it is submitted that the company would be perfectly justified in including it in its balance sheet at £100 although as a matter of fact it had ultimately only realised £80.

The distinction between the two debts may seem a somewhat narrow one, but it nevertheless exists. The decline in the value of the Argentine debt was attributable to circumstances arising entirely subsequent to the date of the balance sheet. Furthermore, a company undertaking business transactions with parties in a country having a fluctuating exchange must experience from day to day, as incidental to that business, losses or profits in exchange, either realised or unrealised, assuming, of course, that the transactions are on a currency basis. The only practical method of dealing with the situation, as between one financial period and another, when preparing accounts, is to revalue the currency floating assets and liabilities by reference to the rate of exchange prevailing at the date of the balance sheet and to deal in the accounts to that date with the profit or loss emerging; profits or losses subsequently accruing would then be regarded as belonging to the new financial period. Any attempt to earmark realised profits and losses in the new financial period as appertaining to the floating assets or liabilities existing at the end of the previous period, and to revalue these floating assets and liabilities accordingly, is tantamount to attributing to the old financial period profits or losses which, from an accountancy point of view, really pertain to the new period. The provision for loss on a book debt owing to the default of the debtor is on an entirely different footing. It is the universal practice to make such provision in the light of all the information available at the time when the balance sheet is being completed: the argument that the provision was unnecessary because at the date of the balance sheet itself there was no knowledge of any impending default by the debtor would find no support among accountants.

While a clear discrimination between correct and incorrect accountancy principles incidental to the valuation of currency floating capital has been suggested above, it must not be assumed that in no cases is departure from such principles justified. Not a few public companies fail to maintain consistent principles; but this forms part of their policy with the express object of erring always on the safe side. For example, if a revaluation of the floating assets and liabilities at a balance sheet date discloses a profit, many public

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companies will not take such profit to the credit if their profit and loss account at that date as it is not a realised one. If, however, such revaluation discloses a loss they will see that provision for such loss exists in the accounts, either by means of a reserve created in some previous year, or, if no such reserve is available, by making a charge to profit and loss account.

V. STOCKS AND STORES PURCHASED IN FLUCTUATING CURRENCY

There now require to be considered points arising in connection with the treatment of stocks and stores purchased in the fluctuating currency.

As has already been mentioned, it is necessary to adopt such a method of accountancy in regard to these as will enable the actual or approximate cost of the stocks or stores on hand at any time, expressed in terms of the fixed currency, to be arrived at. This result can only be achieved by converting the purchase price of the stores from fluctuating currency into the fixed currency at or about the time when each purchase is made, at the rate of exchange then prevailing.

In the case of an undertaking such as a railway, or an electric light undertaking, the stores are bought for the purpose of operating, maintaining or improving the undertaking; in other words, they are purchased for use and not for sale. In the case, however, of a undertaking engaged in manufacture or trading, the stores are purchased with a view to re-sale either in the same form as that in which they were bought, or else in a more highly manufactured state. The treatment of stocks or stores falling under either category, so far as exchange is concerned, is, however, identical in principle.

Stores purchased for use.

Referring firstly to stores purchased to be utilised in the operation, maintenance or improvement of an undertaking, such as a railway, these, if purchased for immediate use, may be charged direct to the expenditure account to which they relate; that is to say, they will immediately form part of expenditure on revenue account or expenditure on capital account. But if, as most frequently happens, a stock of stores requires to be maintained, it is necessary to charge the stores, when purchased, to a stores account, and then when a certain quantity of stores requires to be used, to credit the stores account and charge the appropriate expenditure account. It will be appreciated that it is essential to ensure that whenever stores which have been purchased in the fluctuating currency are charged out to an expenditure account, the expenditure account is debited with the original cost of such stores expressed in the fixed currency; and that it is also essential that at any time the cost of the stores in hand, expressed in the fixed currency, should be capable of ready ascertainment. The method adopted to achieve this is to keep the stores account in terms of the fixed currency. It hardly falls within the province of this paper—which deals with general accountancy principles rather than with detailed methods of bookkeeping—to describe the means by which this stores account is incorporated in the general bookkeeping system, which deals, of course, with the fluctuating currency in which the local transactions are taking place.

Stocks purchased for re-sale.

As regards stocks purchased for re-sale at a profit, the nature of the business may be such that the maintenance of a stock account such as that described above is impracticable. Other means there-

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fore have to be taken to ensure that the stocks in hand at the date of the balance sheet are valued at their approximate cost, represented in terms of the fixed currency. Differing circumstances in various businesses call for different methods of treatment; but the objective is the same. The scope of this paper does not permit of a description of any of these methods.

In referring to the principle that stocks and stores purchased in a fluctuating currency should be valued, for the purposes of a balance sheet prepared in fixed currency, at their cost, it should be observed that this is on the assumption, as regards stocks bought for re-sale, that there has been no decline in the market value (expressed in sterling) between the time of purchase and the date of the balance sheet. If, for example, a certain stock of material had been bought at the price of 12 Argentine paper pesos per yard at a time when exchange was at the rate of 12 pesos to the £, its cost per yard would be represented by £1. Let it be presumed that at the date of balance sheet the Argentine peso was at the rate of 14 to the £, and that the market value of that particular class of stock was still 12 Argentine pesos per yard. The market price at the date of the balance sheet, expressed in sterling, would therefore be about 17s. per yard; and the stock would accordingly require to be written down, for balance sheet purposes, from its cost of £1 per yard to the market value of 17s. per yard.

VI. INVESTMENTS

Before leaving the subject of assets, it is desirable to say a few words in regard to investments in companies domiciled in countries having a fluctuating currency.

In connection with the preparation of the annual accounts of the concern which owns such an investment, the question of the value of the holding may arise, as may also the question of what income can be taken credit for as being derived from the ownership of that investment. In that connection the balance sheet and accounts of the company in which the investment has been made may require to be reviewed. These accounts presumably are expressed in terms of the fluctuating currency, and the question at once arises as to what rate or rates of exchange should be applied to the currency figures appearing therein in order to show their fair equivalent in terms of the stable currency.

For example, let it be assumed that a limited company in England owns the whole of the share capital in a Brazilian company and that the balance sheet of the Brazilian company (which would be expressed in milreis, the currency of that country) may be summarised as follows:—

as follows.—		Balance Sheet	
	Milreis		Milreis
Share capital	100,000	Debtors	136,000
Creditors	50,000	Cash	19,000
Credit balance on Profit & Loss Account	5,000		
	<hr/> 155,000		<hr/> 155,000

Let it be presumed that the English company had acquired the whole of this share capital in the above company at par at a time when the value of the milreis was 6d. And let it be presumed that at the date of the foregoing balance sheet the value of the milreis was 5d.

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The investment would first appear in the books of the owning company at cost, namely £2,500—i.e. 100,000 milreis at 6d.

At first sight it might seem as if this investment was fully represented, at the date of the balance sheet quoted above, by tangible assets, because not only are the 100,000 milreis intact, but 5,000 milreis have been added in the form of profits earned and retained in the business. But such is not the case when the balance sheet is reviewed from the standpoint of sterling, as the 105,000 milreis at 5d. are only equivalent to £2,187 10s. Therefore from the point of view of the English company which owns the investment, the shareholding is unrepresented by tangible assets to the extent of £312 10s.

In the case quoted above it has been assumed, for simplicity's sake, that the Brazilian company has no fixed assets. If, however, it happened to own fixed assets as, for example, land and buildings, the rate of exchange at the date of the balance sheet would not, as regards assets of this class, have any significance. The fixed assets would require to be valued by reference to the rate of exchange prevailing at the time when they were acquired or constructed.

VII. OPERATING PROFITS EARNED OR LOSSES SUSTAINED IN A FLUCTUATING CURRENCY.

Average Rates of Exchange to be adopted for Conversion Purposes.

There now requires to be considered the method by which profits earned (or losses sustained) in a fluctuating currency should be converted into terms of a fixed currency. The general basis, as already mentioned, is that they should be converted at the average rate of exchange prevailing during the period.

In regard to the length of the period in respect of which the daily average rate of exchange should be taken, similar remarks apply as in the case of the conversion of expenditure incurred on capital account, namely that the more evenly the profits are earned, and the less widely the exchange fluctuates, the longer the period that can safely be taken. It may, for instance, be quite justifiable to take a period of as long as a year. If, however, the profits are not earned more or less evenly over the year, and if the fluctuations in the exchange are considerable, shorter periods will probably require to be taken, say, periods of six months or three months, or of one month. In certain kinds of business—and especially in those classes of business where heavy stocks of raw or of semi-manufactured material have to be held—the ascertainment of the profits in terms of the fluctuating currency at so short an interval as each month may involve a considerable amount of additional accountancy work. If, however, reasonably accurate results can only be obtained by these means, no other course is open. The circumstances of each case must be carefully considered on their merits before a conclusion is reached as to what should be done in this respect. On the one hand there is the natural desire to avoid all unnecessary trouble and expense; but on the other hand, if proper reliance is to be placed upon the periodical statements of account, these must be accurate enough for all practical purposes.

It may be well to observe here that the figure of profits, arrived at in terms of the fixed currency, as the result of converting at the average rate of exchange profits earned in the fluctuating currency, is not a final figure, but will always need some adjustment.

Leaving out of consideration for the moment accounts of businesses where the conversion of fluctuating currencies arises, it will be appreciated that under a double-entry bookkeeping system the correctness of the figure of profits shown by a profit and loss account

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is in effect proved by the preparation of a balance sheet; in other words, if profits have been earned they are represented by an accretion in the assets of a business or by a reduction in the liabilities, or partly by one and partly by the other. It is as a rule impossible or impracticable to earmark any particular asset as representing any portion of the profits earned in a period, or to earmark the reduction in any particular liability as being due to the same cause. Floating assets and liabilities are fluctuating in amount from day to day: individually they may increase or decrease quite irrespective of the amount of profits being earned. If, however, there is an increase in the excess of the assets over the liabilities as between two dates (after making allowance for any fresh capital introduced or any moneys drawn out) it can definitely be said, in a normal case, that this is due to profits having been earned during such period.

The foregoing principles may now be considered in relation to a business which is operating in a country whose currency fluctuates, but which is owned by parties in a country with a fixed currency.

Profits and Losses to be adjusted by Differences in Exchange.

Let it be assumed that such a business was operating in the Argentine Republic and that it earned, in a financial year, 100,000 Argentine paper pesos, and that the average daily rate of exchange for that period was 12 Argentine pesos to the £ sterling. The profit and loss account would then show a profit, in terms of sterling, of about £8,333. There are, however, other factors affecting the true profit of the period which will not yet have been taken into account. In practice a number of these factors are usually present in conjunction; but for the sake of simplicity it may be well to consider an example in which two factors alone exist.

Let it be presumed that in drawing up the balance sheet of the business, the profit of 100,000 Argentine pesos, which has been earned, is represented as follows: 80,000 pesos were remitted to England towards the end of the financial period on a date when the rate of exchange was 14 pesos to the £; these therefore realised about £5,714 and formed part of the bank balance in England at the balance sheet date. The balance of 20,000 pesos was represented by a bank balance in the Argentine at the balance sheet date. In common with other floating currency assets it was converted, for purposes of the balance sheet to be prepared in England, at the rate of exchange at the balance sheet date. Such rate was 14½ pesos to the £, and the balance was therefore valued at about £1,380.

Summarising the position, therefore, the 100,000 Argentine pesos, representing the net profit, which had been converted for bookkeeping purposes at the average rate of exchange, and were expressed in sterling at £8,333, were, at the balance sheet date, found to have a value of only £7,094 (namely £5,714 plus £1,380). There was therefore a loss on exchange, which arose partly from the fact that the bulk of the profits earned were remitted at a lower rate of exchange than that at which the figure of profits had been converted from book-keeping purposes, and partly from the fact that the portion of the profits which had not been remitted but had remained in a local currency bank account had declined in value by the balance sheet date.

In the example just considered it had been assumed that the whole of the remittance made was in respect of profits earned during the financial period in question. In practice, however, a remittance made during a particular financial period may be made out of funds arising from the realisation of currency floating assets in existence at

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the beginning of the period. If the rate of exchange at which such remittance is made is more favourable than the rate adopted for valuing the currency floating assets at the beginning of the financial period (that is to say, at the date of the previous balance sheet), a profit on exchange would automatically emerge. Such a profit would not, it is true, arise out of the operations of the company on what may be called trading or working account during the period; but it is nevertheless a profit attributable to the period, as it has arisen during the period and is in respect of a floating asset.

Again, a remittance may not be wholly in respect of profits. The remittance may in part be in respect of stocks and stores which, let it be presumed, are purchased in England and dispatched to the Argentine. If the rates of exchange at which the remittances are made are different from the rates prevailing when the stores are dispatched from England to the Argentine, a difference in exchange—either a profit or a loss—emerges in respect of this.

From what has been said above, it will be appreciated that it is generally impracticable—as it is also unnecessary—to ascertain the exact composition of a difference in exchange arising at the end of a financial period on the compilation of a balance sheet. Whatever difference emerges will require to be written off to profit and loss account—except, of course, to the extent to which it may be a difference attributable to capital. This latter matter has already been discussed.

Origin of Difference in Exchange.

While however, it may be impracticable to endeavour to ascertain the exact composition of a difference in exchange appearing on the drawing up of a balance sheet at the end of a financial period, it is to consider whether the difference which does emerge is in accordance with general expectations, having regard to the course of exchange throughout the period and other factors. If it does not accord with what might be expected, the matter should be looked into, having regard to the possibility of some bookkeeping error having been committed.

Conversion of Profits at Average of Remittance Rates.

The suggestion is sometimes put forward that instead of the profits being converted at the average rate of the period during which they were earned, they should be converted at the average rate at which actual remittances were made during such period. By this means, it is argued, a smaller difference in exchange will emerge in the accounts. This may very well be the case; but it does not therefore follow that the accounts are more accurate. In fact, the reverse is probably true. The profits of a business are earned from day to day; but remittances of such profits to the country having the fixed currency do not usually take place daily, but at longer intervals, partly because very frequent remittances entail corresponding time and trouble, and partly, it may be, with the object of retaining funds temporarily in the fluctuating currency until such time as the exchange rate seems favourable for a remittance. The true operating profits are therefore fairly represented by the conversion of the currency figures, for bookkeeping purposes, at the average of the daily rates prevailing during the period; and the difference arising in connection with the remittances is not an operating profit or loss but a financial profit or loss on exchange, and as such should be shown separately. Any attempt to merge it with the operating profit, which in effect would be the result of adopting the remittance rates for the conversion of the profits figure, is therefore to be deprecated.

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It will now be appropriate to refer to one or two general matters in regard to the treatment of fluctuating currency in accounts which do not fall conveniently into any of the sections into which this paper has so far been divided.

The first of these concerns the question of accuracy.

VIII. DEGREE OF ACCURACY OF ACCOUNTS

While one of the essentials of an accountancy system is accuracy, it must always be remembered that absolute accuracy may not be essential, but that relative accuracy may sufficiently meet all requirements. It will be clear from the description of the bases of conversions from terms of a fluctuating to terms of a fixed currency, for bookkeeping purposes, that the adoption of an average of the daily rates of exchange for the purpose of converting the gross revenue and expenses of any financial period produces figures which are not accurate in the strictest sense, though they are approximately correct. If the margin of error is obviously very slight, it can certainly be ignored. One obvious method of practically eliminating the margin of error would be to convert the figures relating to the revenue and the expenditure of each day at the rate of exchange prevailing on that day; but this would clearly entail an enormous amount of additional clerical work the necessity for which it would be difficult to justify.

In reviewing, in individual cases, the probable margin of error and in coming to a decision as to whether its existence is justified, or whether some more accurate (but more elaborate) method of conversion would be desirable, an important point to consider is whether the error is one which is automatically corrected (either in the accounts of the same financial period or in those of a subsequent financial period) or whether it is of such a character that it will be perpetuated.

The above observation calls for some short explanation. In a business where no addition to fixed assets is taking place (in other words, where no expenditure on capital account is being incurred) any profits earned must be represented by an accretion to the floating capital, or else by remittances to the country having the fixed currency, that is to say, the country where the owners of the business are domiciled. If by reason of a somewhat arbitrary basis of converting the figures representing the gross revenue and the expenditure from fluctuating to fixed currency, for bookkeeping purposes, the profit is somewhat understated or somewhat overstated, this profit is automatically adjusted, partly by the exchange profit or loss on remittances, and partly by the revaluation of the currency floating assets less liabilities at the date of the balance sheet at the rate of exchange then current. Within limits, therefore, it is immaterial, in such a case, whether the profits are ascertained monthly and converted at the average of the daily rates for the month, or whether they are ascertained quarterly, half-yearly or yearly and converted respectively at the average daily rates for the quarter, half-year or year. A different profits figure is arrived at in each case; but in each case a different exchange profit or loss figure emerges; and when the two figures are taken in conjunction the result is exactly the same in each case.

The fact, however, that the net profit ultimately arrived at is the same is no necessary justification for adopting arbitrary rates of exchange in converting the currency figures of expenditure and gross revenue in the profit and loss account and then showing on the books a large difference in exchange which is thereupon written off to profit and loss. In such a case, the difference in exchange does not wholly represent a real profit or loss on exchange, but would be composed

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to a considerable extent of differences arising from what may aptly be termed loose accountancy methods. The aim of accountancy as regards a profit and loss account is not merely to disclose the ultimate net profit, but to show as accurately as possible how such profit has been earned. And in that connection it may be very desirable that the account should clearly discriminate between a profit on what may be called trading or operating account and a profit on exchange. The point may, for example, be of special importance where the profits of a business for a series of years have been reviewed incidental to the possible sale of such business, or where profits are being quoted in a prospectus offering the shares or debentures of a limited company for subscription by the public. Or, again, it may be desired to compare figures of expenditure and of revenue, class by class, over a series of years. In this case it is clearly necessary that the conversions of these figures from terms of fluctuating to terms of stable currency should be made, as regards each year, on the most accurate basis which is practicable, as otherwise the comparison may lose much of its value.

If, however, capital expenditure is being incurred in the fluctuating currency, and the method of converting the currency figures representing this expenditure into terms of the fixed currency is too arbitrary and a material inaccuracy results, such inaccuracy, as mentioned earlier in this paper, is perpetuated, as the capital expenditure is permanently embodied in the books either at too high or too low a figure. This means that the profits of the financial period ended on the date of the balance sheet have either been overstated or understated. The same overstatement or understatement of profits exists, of course, if a currency floating asset has been converted, for bookkeeping purposes, at too high or too low a rate of exchange. A currency floating asset, however, is not permanent: it changes in form from time to time and is subject to revaluation or to realisation into the fixed currency. To what extent, therefore, it has been overvalued or undervalued at the end of one financial period (thereby affecting the profits of that period as shown by the books) a corresponding adjustment automatically takes place during or at the end of the next financial period.

IX. REQUIREMENTS OF A SCIENTIFIC ACCOUNTING SYSTEM

The maintenance of a proper system of dealing, in accounts, with a fluctuating currency involves, it must be admitted, certain additional clerical work. Furthermore, the system cannot be wholly free from complications. Neither the additional work nor the complications are, however, so great as might at first sight be imagined.

So far as the additional clerical work is concerned, it will be remembered that in the main the conversions from terms of the fluctuating to terms of the fixed currency deal with totals and not with individual items. And as regards the complications, these are apt to disappear when once the main principles to be borne in mind and the main objects sought to be achieved are thoroughly understood.

In practice one not infrequently experiences cases where those owning or administering a business which is being carried on in a country whose currency fluctuates allow the records to be dealt with throughout a financial period on a basis which assumes that the currency is a fixed one. Then at the end of the financial period they seek to make the necessary adjustments in preparing the balance sheet and if insufficient data exists—as is very probable—for the purpose of making proper adjustments, they are content to make approximate adjustments; and they claim that the accounts will then

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be sufficiently accurate for practical purposes. Their avowed object, of course, is the saving of time and expense.

It is hardly possible to emphasise too strongly the inadvisability of such a procedure. The saving of time and expense is a trivial benefit to set against the possibility that the accounts so prepared may be inaccurate to a material extent, bearing in mind that no adequate means are then probably available to prove whether all necessary adjustments have in fact been made.

X. CONCLUDING OBSERVATIONS

Before bringing this paper to a conclusion the writer wishes to make a few general observations.

In the first place he desires to make it clear that all the points discussed and principle laid down have been dealt with from the standpoint of British accountancy practice and British law.

The second observation is that anyone attempting to prepare a paper upon a somewhat specialised subject is under a peculiar difficulty if he knows that some of his audience have had a wide practical experience of the matters treated while to others many of the points discussed constitute new ground. To those of the audience who fall under the first category apologies may be needed on the ground that the subject matter of the paper is unduly elementary. On the other hand those who belong to the second category may quite conceivably complain, with perfect justification, that too great a knowledge of the subject on their part has been taken for granted and that, as a consequence, they cannot appreciate fully some of the explanations given or arguments used. Of both classes of audience, therefore, the writer has to ask indulgence.

Apart altogether from the advantages which an International Congress of Accountants confers on us as professional men in the interchange of views and ideas on accounting and kindred subjects, there are the wider benefits which we all derive from mixing with each other as citizens of various countries in friendly intercourse. By so doing we may hope to obtain some insight into each other's outlook and mentality, and to appreciate something of the special difficulties and problems with which each nation is confronted.

CHAPTER NOTES

TORONTO

Messrs. Shiach, Dean and Dingle, who constitute the program committee for Toronto Chapter this season, have prepared a tentative program of eight meetings, which program has been passed along to the Chapter executive for consideration, and final arrangements are now being made with speakers.

It is expected that the first meeting of the season will be on October 6th, and that the subject matter will be the price situation in Canada, and the possibilities of the National Recovery program being tried out in the United States. As usual, members will be directly notified of this meeting.

Toronto Chapter executive hopes to be able to arrange a substantial saving in the expense of dinner meetings to its members this season.

Deflating the Balance Sheet to Inflate Earnings

BY WILLIAM R. DONALDSON
Miller Donaldson & Co., New York

(From "The Iron Age", New York)

ACROSS the financial pages of our daily newspapers the last few months has appeared a succession of corporation annual statements in which reference is made to substantial write-downs of plant and equipment. Printed reports sent to stockholders amplify and explain these write-downs, some amounting to many millions of dollars. It has become the fashion to write down and write off, and the result is this procession along the avenue of corporate accounting practice. And like most fashions, the idea in which they were conceived soon becomes obscured by this twist here or that bow there, so that the mode in millinery goes cavorting off on a tangent that has no relationship to the basic design.

We read the story of George Bernard Shaw's recent visit to a California motion picture studio, during which he remarked to a pretty and well known movie star as she finished the sequence of the picture she was making: "Why does a girl with a nice face like yours wear a hat like that?" The report goes that she hurriedly left the set for her dressing room, there to break into tears. So, it can be said for some of the corporations which are following the mode of the hour: "With a nice face like yours and the nice figure you have attained during your successful lifetime, why do you rush off in the darkest, dreariest days of depression to follow a fashion that may well become your lean, anemic sisters, but not you." We surmise in a few years such corporations will regret their impetuous action.

It is the purpose of this article to review the reasons for this mode of the hour, what it accomplishes, and the effect it has on present and future financial statements and operating results of corporations which follow it. Everywhere directors of corporations and financial and accounting executives are discussing what should be done with their plant accounts. They see their competitors indulging in the write-off practice, and they realize that in some respects advantages appear which would tend to give their competitors the edge during future years. They feel they should proceed along the road to deflation, and they are right to a certain extent. But when deflating the balance sheet results in inflating future earnings, they should think twice before taking the step.

It is the income or earnings statement that tells the real story of the success of the worth of an enterprise. "What are the earnings per share?" is the popular question rather than "What is the book value per share?" And it is toward increasing income toward raising up the "earnings per share" that management effort is primarily directed. During the last several years, the element of expense existing in every business, which stood out so prominently in the income statement as "Depreciation of Plant and Equipment," has worried management. It is a fixed charge that rips away a good chunk of the "income before depreciation" and turns some nice black figures into vivid red ones.

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When sales were in good volume, prices high and plants fairly active, depreciation represented a minor part of the total income from sales. But now that the wheels have ceased to whirl so evenly and sweetly, there stands the old rock "depreciation" as a formidable obstacle toward attaining black figures in the income statement. "It's only a bookkeeping item and means nothing. It should be eliminated," says one anxious manager. "We are running only 20 per cent of capacity and therefore we should have only 20 per cent of the depreciation we had when we were running full," speaks up a treasurer. "Our plants are all shut down; so we have no depreciation expense," adds a worried president. And the another executive declares: "If we have no values on our books for our plant and equipment, we will have no depreciation because zero dollars multiplied by 5 per cent equals zero. Nobody pays any attention, anyhow, to what we carry our plants at on our balance sheet. We have plenty of cash, owe nothing much, and are in splendid net current asset position with ample working capital. Our stock is without par value and so we can shrink up the stated value, make a capital surplus and, bang, charge off the whole works. Our stockholders will compliment us on how conservative we are, carrying all our vast facilities at \$1, and from now on, hurrah, no more depreciation. We are bound to show good earnings. Also, we shall get a better break on our own profit-sharing bonus."

Is Unfair to Stockholders and Competitors

So runs the logic of the enterprises which have entirely written off their plants and equipment, and this is likewise true of those which have inordinately slashed plant values below fair worth. It is only natural that in these dark days of corporate earnings all kinds of straws should be grasped at to decrease losses and eventually turn toward profits. It is the management's job to earn profits and this they seek to do by all acceptable means. But it is incorrect and unfair to the corporation's own stockholders to turn out income statements in future years showing no or insufficient expense for depreciation, and it is unfair to competitors to fix prices below cost, which is what is apt to happen when depreciation is not considered an element of cost to be recouped in the selling prices determined upon.

Of course the old discussion arises as to what is depreciation and why it has to be included as an element of cost of doing business, since it does not represent a cash outlay during the year reported on. However, it is now everywhere recognized that the wear, tear and obsolescence of the plant and equipment (the usage and wastage of capital) which occurs regularly each year does represent a cost to be considered and weighed in when stating the year's earnings. If the capital invested in plant and equipment is wiped off in one fell swoop instead of apportioned over the years of useful life, these years will not absorb their proper share of this wearing-out process.

Out of the whole question comes this dominating consideration. After plant and equipment is written down or otherwise adjusted in value, will the future years' income account continue to bear fair and reasonable annual charges for depreciation of the plant and equipment actually in use during those years? If the plan of adjustment is such as to accomplish this result, then it is not believed any serious quarrel can be picked over the manner or the method or the extent of adjusting present valuations.

From the balance sheet viewpoint it is somewhat a matter of whether one prefers vanilla or chocolate ice cream. Plant and equipment accumulated over a long period of years is bound to represent heterogeneous valuations, some low because of acquisition in days of low prices, some high because purchased or built in times of high

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prices. An enterprise is presumably in business to stay for many years. It spent money to acquire these assets, and as they wear out or tend to become obsolete, it is hoped and expected that the earnings derived from using them will pay back the original outlay. If any part has ceased to be usable, and would be gladly parted with if a buyer appeared on the horizon, then the money poured into such part, not yet recouped by depreciation charge-off, has of course gone for naught other than what such buyer might be willing to pay for it. Writing down to market value plant and equipment definitely abandoned as unusable is proper and defensible. The loss in investment has occurred and in the future these assets will not contribute anything toward making the product which is to be sold and from which earnings will be derived.

Writing Down to "Market" Value

The question will arise, what is the market value to which it should be written down? These days there is no real market for surplus plant and equipment, so that it cannot be accurately determined. However, if, based on good business judgment, some round sum value is assigned at which it is believed during the course of the next few years the plant and equipment can be ultimately disposed of, then the enterprise will have acted fairly to adjust its valuations. Thereafter depreciation need not be charged off and when the assets are actually disposed of the difference between the assigned residual value and the price received will constitute the further adjustment one way or the other. There can be no dispute about this treatment of this sort of assets, and perhaps it is owed to stockholders to disclose to them on the balance sheet the unusable plant and equipment available for disposition at a value commensurate only with what it is expected can fairly be obtained.

Let us consider the view of those corporations which assembled a group of subsidiaries and plants in the hey-day of corporate mergers and consolidations and set up on their books these plants and the equipment at their then appraised value. They have had to take each year since a good healthy bite of depreciation, because in those years construction and machinery costs were high and the values on the books reflected this condition. Construction costs have tumbled 25 to 30 per cent since those years, and machinery prices as much, if not more. Such consolidations approach this question of reducing depreciation by claiming that, as the present sound replacement value of the assets is substantially below book worth, they should be written down to present worth. They counter the argument that cost must be recouped through the operating account by stating that it is not cost which must be recouped but an amount sufficient to replace the depreciating assets when their useful life has terminated. Or to put it another way, that since the lowered annual depreciation will eventually deduct out of earnings sufficient entirely to replace the assets, it is not necessary, or right, to deduct amounts greater than will be necessary to replace them. They say that if depreciation were continued on the basis of the original high cost or appraisal value, earnings would be charged with an excessive amount. Thus, the two schools of accounting thought and practice: depreciation should be on basis of (1) cost, (2) replacement value.

Do Current Prices Represent Sound Value?

At any rate, no matter upon which side of the argument one finds himself, should a corporation write down its plant and equipment to present sound value less observed depreciation in order to lower the future annual depreciation charge, the action can scarcely be criticized

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as improper or as tending to inflate unfairly the earnings of future years. But what is sound value is even debatable. It is supposed to be the present cost to build or to acquire new. With a construction and machinery market as we have today—or rather lack of any market—we wonder whether currently quoted prices may be said to reflect sound value.

But he who seeks to follow some logic behind his determination to write down his company's plant, and would like to eliminate future depreciation entirely if he dared, advances the thought that it is not sound value which should be the base, but market value. He points out that if a brand new competitor were to enter the arena afresh this competitor would go out and buy one of the many plants available, set up modern machinery which he can buy used from many dealers, and launch into business at a distinct advantage, because in future the low cost of his plant and equipment would make the depreciation charge very low. Therefore, when asset values are to be adjusted, our "depreciation-saver" contends they should be reduced to the point where future depreciation charges will enable the enterprise to compete with a new entrant into the business. Through such reasoning we have the executive who wishes to cut his assets to "market value" in order to increase future earnings. "Distress value" is a better designation; a market presupposes buyers and sellers and for the purchase of plants there are no buyers these days.

There are many variations of these approaches. Some believe that plant and equipment actually in use (though perhaps not to capacity) should be written down to sound value; such not now in use but intended and expected to be used in future when activity returns should be reduced to market value to keep it competitive with new manufacturers; and such as is definitely set aside as not usable written off entirely or to a nominal amount. The reasons and the methods are as variegated as the colors of fashionable millinery.

Tax Provisions

In the struggle for more and better earnings, the United States Treasury Department stands adamant. The income tax law provides that the actual cost of plant assets constitutes the base for the annual percentage charge-off of depreciation allowable as a deduction in income tax returns. Twist balance sheet values around as you will, slice depreciation to zero or to any amount, and it matters not. When the tax return is prepared the old-fashioned allowance for depreciation must appear on line 22. So as not to be taken too literally it should be added that loss in useful value of plant and equipment may be deducted in the year sustained, but to secure this deduction it is necessary almost to establish that the plant has been abandoned to the tax collector and the equipment carted to the dump. Adjustment in values may have some slight bearing on insurable worth, but whether left high or slashed low the insurance company will be guided by insurable values rather than book figures. In tax districts where book figures play some part in the judgment of assessors in fixing valuation, writing down assets may result in decreasing taxes.

With all this movement toward deflating plant and equipment values it has not yet taken the form of a grand rush. Many corporations are standing pat, feeling that the slough of the depression is no place from which to view the worth of plant and equipment, assets which have served for many years and will continue in future to serve in the quest for profits. They reason that as the future dawns they can chart their course toward earnings year by year, altering it when necessary, and analyzing and subdividing depreciation to

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meet the peculiar accounting and financial problems of the year and pointing out to stockholders the significance of these figures from the competitive angle. They feel the balance sheet should always show the cost of plant and equipment and its orderly extinguishment through regular depreciation charges. They believe that an established business should act like one and not juggle its cost of fixed assets from decade to decade as the wind happens to blow.

Everyone knows that fixed asset account in the balance sheet is not taken literally as expressing the real worth of those assets. It normally presents what they have cost and what so far has been written off for depreciation. When assets go out of service and are no longer of use in the business it seems proper to add to depreciation reserve and deduct in the income account, or even in the surplus account an amount for extraordinary depreciation and loss in value. But otherwise it is not felt by many executives that the gross or net value of assets actually usable, ready for use and intended to be used if orders were on hand, should be adjusted upward or downward to reflect changes from year to year in replacement worth or to give effect to lack of use or utility because of insufficient volume.

In retrospect we oftentimes wonder why we did the things we did in 1928 and 1929, why we followed practices that more sober thought proved faulty, even vicious. May we hazard the firm conviction that the "writers-off" who join the fashion parade of 1932-1933 will in a few years be moved to tears by the ill-becoming \$1 value with which they clothed their plant and equipment.

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"Have you the firmness that enables you to keep on doing your duty in the face of ingratitude and criticism?"

"I guess so. I once cooked three weeks for a camping-out party."

* * * * *

She: Who is the millionairess who owns that car?

He: That little beggar girl in the film who made you cry your eyes out yesterday.

COST AND MANAGEMENT

THE TREND OF PRODUCTION COSTS

Commodity prices as measured by the Dominion Bureau of Statistics index number which is based on the year 1926, advanced from 67.6 in June to 70.5 in July. The following is a comparison by main groups:

	July 1932	June 1933	July 1933
Foods, beverages and tobacco	61.3	64.1	67.8
Other Consumers' goods	77.4	75.0	75.3
All consumers' goods	71.0	70.6	72.3
Producers' equipment	88.1	86.6	86.6
Building and construction materials	75.6	78.9	80.7
Manufacturers' materials	75.6	78.9	80.7
All producers' goods	62.8	65.5	69.8
All producers' materials	60.0	63.1	67.9
All commodities	66.5	67.6	70.5

The principal advances in July were in the following: Dried fruits, grains, flour and milled products, vegetable oils, vegetables, furs, hides and skins, unmanufactured leather, eggs, raw cotton, cotton yarn and thread, sash cord, silk thread and yarn, raw wool, wool yarns, brass and copper products, lead and its products, zinc and its products, solder, dyeing and tanning materials, drugs and pharmaceutical chemicals. The principal declines were in aluminium and salt.

TORONTO-HAMILTON GOLF AT LAKEVIEW CLUB

The date June 26th, set for the golf event for Toronto, Hamilton and Central Ontario members, at Lakeview Golf and Country Club, caught a large proportion of our members either getting ready for vacations or getting ready for a boom in business, and only eleven turned out from Toronto and one from Hamilton. Though missing some of those who have been steady supporters of our golf events, including Stanley LeBrocq of Hamilton, who comes to play, and Major Gerald Earnshaw of Guelph who comes to draw conclusions, we had the following: G. H. Houston, president; W. M. Lane, past chairman of Toronto Chapter; J. W. Spence, chairman of Toronto Chapter; Harold P. Wright, Chairman of Hamilton Chapters; C. D. Landell and C. P. Roberts, directors of Toronto Chapter; W. A. McKague, general secretary; and A. W. Island, C. Warnes, G. Abrams, Mr. Appleford, and Mr. McKeown of Toronto. The unaudited reports stated that Charlie Landell and Mr. McKeown tied at the even 100. Harold Wright of Hamilton came through in 103 and undoubtedly would have done better had the rest of his foursome given him a closer running. A vigorous thunder storm interrupted but did not spoil the game, and the day concluded with an excellent dinner in the club-house, and a vote of thanks to Percy Roberts for securing the use of the Lakeview club for our members.

COST AND MANAGEMENT EXAMINATIONS, 1933

The following are the names and marks of candidates who were successful at the examinations of the Canadian Society of Cost Accountants and Industrial Engineers held in May, 1933.

First Examination, Cost Accounting only:—

P. Bernstein, Montreal	63
C. W. Cassidy, Montreal . . .	62
E. J. Sevigny, Montreal . . .	61
C. W. Webber, Montreal . . .	71
J. E. Beauvais, Montreal . . .	76
H. T. Burpee, Toronto	60

J. Banigan, Toronto, passed three papers as follows: Bookkeeping, 83; Law, 73 and Cost Accounting, 60.

Second Examination:—

	Cost Accounting	Business Organization
E. Landermann, Montreal . . .	—	63
J. D. Hannen, Montreal	—	66
J. I. Bernier, Montreal	—	73
L. Viau, Montreal	76	85

NEW MEMBERS

The following are new members of the Society:

Montreal

Shink, T. A., Mount Royal Hotel Ltd.

Toronto

Screaton, A., Toronto Hydro-Electric System, Toronto.

Scully, V. W. T., J. D. Woods & Co. Ltd.

Collard, J. L., Regal Films Ltd.

Hamilton

Klager, Gordon T., Dominion Woollens & Worsteds Ltd., Hespeler, Ont.

Winnipeg

Howard, Milton T., C.A., Peat, Marwick, Mitchell & Co.

THE NATIONAL COST CONFERENCE

We are in receipt of an official communication from The Institute of Cost and Works Accountants, London, Eng., extending an invitation to any of our members who may be going to the old country to attend and take part in the twelfth national cost conference. The conference will be held in London on October 19-21, and the annual banquet, at which H.R.H. the Prince George will be the guest of honour, on the evening of October 20. A very interesting and informative agenda has been drawn up.

